Challenges of Transforming Riba-based Government Debt in Pakistan to *Sharī´ah*-Compliant Instruments

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Abstract

Substantial progress was made in Pakistan during the first decade of twenty first century towards the transformation of financial activities to *sharī´ah* compliance. This was based on earlier work of many scholars spread over several decades after the inception of Pakistan. The parallel approach adopted in the country has the potential to reach the ideal, if and only if, concerted efforts from key national institutions continue to move forward. Progress has been much slower in respect of Islamisation of government debt obligations, although the *sharī´ah*-complaint instruments have been used successfully by the private sector to mobilize resources through *musharaka* based TFCs. This paper identifies the causes for slower growth and the benefits of overcoming the challenges which are: eliminating the domestic debt held by the central bank; acquirement of *sharī´ah* compliant debt obligations by SBP to conduct monetary policy; challenges relating to the issuance of Government of Pakistan (GoP) *Ijara Sukuk* - limited availability of non-encumbered government assets*;* creating appropriate non-interest-based benchmarks for linking *sharī´ah*-compliant returns and gradually transforming the mindset of investors towards broader acceptability of *sharī´ah*-compliant products through publicity campaigns. The paper suggests that an asset survey be undertaken by the government to identify and document the assets for enabling future *sukuk* issuances. Some other suggestions are also offered to speed up the process of transformation towards *sharī´ah* compliance

Key Words: GoP; Ijarah Sukuk; Sharī´ah-compliant instruments; Definition of Riba, Central Bank Balance Sheet; Ibn Khaldun; Islamisation of domestic government debt;

1. Introduction

Substantial initial progress was made in Pakistan during the first decade of twenty first century towards the transformation of financial activities to *sharī´ah* compliance. This was based on earlier work of many scholars

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spread over several decades after the inception of Pakistan[1]. Much earlier, Allama Muhammad Iqbal very clearly enunciated the need to transform the financial system to *sharī´ah*-compliance in his Persian *Mathnawi* "*Pas Cheh Bayed Kard Ay Aqwam-i-Sharq'* (What Should Then Be Done O Nations of the East?)[2]"

ایں بنوک ایں فکر چالاک یہود
نور حق از سینۂ آدم ربود
تا تہ و بالا نہ گردد ایں نظام
دانش و تہذیب و دیں سودائے خام

These banks, the result of clever Jews' thinking,
have taken away God's light from the heart of man.
Unless this system is destroyed completely,
Knowledge, religion and culture are mere empty names.

Although the present situation is far from the above ideal, the parallel approach adopted in our country has the potential to reach this ideal, if and only if, concerted efforts from key national institutions continue to move forward. Since the adoption of a three-pronged strategy by the SBP and the establishment of the first full-fledged Islamic bank (Meezan Bank) in 2002, together with opening of stand-alone Islamic banking branches of conventional banks, steady progress has been witnessed in their evolution. The share of Islamic banking assets to total banking assets increased from 0.31% in December 2002 to 6.4% in September 2010. This gradual transformation was achieved by a remarkable performance of Islamic banks whose asset growth outpaced those of conventional banks by a wide margin during this period.

Progress was much slower in respect of Islamization of government debt obligations, although the *sharī´ah*-compliant instruments were used successfully by the private sector to mobilize resources through *musharaka* TFCs. The first rupee-denominated[3] *sharī´ah*-compliant

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[1] Aurangzeb Mehmood (2002) provides a review of these efforts starting from the inception of Pakistan. Efforts during 1988 to 2003 are detailed in Chapter 14 of History of the State Bank of Pakistan 1988-2003.

[2] Allama Iqbal wrote this *mathnawi* (long poem) in Farsi in 1933 after his visit to Afghanistan (along with Syed Suleman Nadvi) at the invitation of then Ruler of Afghanistan.

[3] In Pakistan, the first *sharī´ah* -compliant Euro-denominated *sukuk* was issued by the Government of Pakistan in 2005 to raise foreign exchange to finance current account deficit.

instrument was issued by the government in September 2008[4]. Since then, the share of GOP *Ijara Sukuk* has gone up from zero in June 2008 to 1.8% in November 2010 in government domestic debt. It seems that the transformation of government debt to *sharī΄ah*-compliant instruments is much more challenging than the transformation of conventional banking instruments. Why is that so? Table 1 provides a glimpse of the enormity of transforming Pakistan's total debt and liabilities to *sharī΄ah* compliance. This brief paper identifies those challenges only for the major part of total debt and liabilities due to Government Domestic Debt and also notes that there are great benefits embedded in overcoming each challenge from macroeconomic management point of view. Some modest suggestions are also offered to speed up the process of transformation towards *sharī΄ah* compliance.

2. The First Challenge: Getting Rid of Government Domestic Debt held by the Central Bank

The stock of outstanding government domestic debt stood at Rs 5294.7 billion as on December 2010 as shown in Table 2. Outstanding amount held by SBP stood at Rs 1432.5 billion or 27.1% of total domestic debt. Accumulation of this debt comes about through a seemingly innocuous financial transaction between Government of Pakistan and the State Bank of Pakistan. With a very simple book entry, SBP credits the Rupees required by the government and book a liability as well as an asset (called Market Related Treasury Bill) in SBP books of accounts. The simple nature of this transaction conceals one of the greatest financial evils invented by financial wizards. This evil is recognized well by the scholars and economists all over the world, yet continues to be still practiced by some governments, leading to creation of excessive or hyperinflation.

What is wrong with this simple transaction and why this should be banned altogether? The answer, coming from "common sense" is also very simple. The money or purchasing power created in this manner, and transferred to the government, comes out automatically, without any real productive business activity, taking place neither in present nor in future. This is a unique kind of loan, where the principal created also seems to be very similar to *riba*, not to mention the interest received by the SBP which definitely falls under the following definition of *riba*:

[4] The details of rupee-denominated GOP *Ijara sukuk* are provided in SBP, FSCD Circular No. 13 dated September 06, 2008. Annexure-"C" of this circular, which explains the structure and documentation, is also annexed with this paper for ease of reference.

"*Riba*" means any stipulated payment over and above the principal lent in consideration of the time given for repayment, either on simple or compound basis, or any discount given on assignment of debt or any financial paper representing money".

Above definition is from the Report of Raja Zafar ul Haq Commission[5]. This Commission took a perplexingly lenient view of the government borrowing from SBP by stating that "Government's transactions with the SBP are of a book-keeping nature. It is proposed that Government would no longer pay interest on SBP holding of TBs; future borrowings will continue as before except that it would be on non-interest basis".

As pointed out earlier, the "principal" created through a book-keeping entry by SBP seems to be clearly a kind of *excess* over nothing and, therefore, seems to be a grave injustice and resembles *riba* in its essence. Some of the arguments that establish this similarity are as follows:

(i) With this transaction, a rupee amount (Principal) is transferred by SBP to government. While this transfer is between only two parties (SBP and government), an injustice is created that affects every agent in the economy through increase in prices due to excessive printing of currency.

(ii) According to Baeck (1991), "For Al-Maqrizi, price inflation caused by monetary manipulation was not just a monetary phenomenon. A sick currency was the product of a morally sick society."[6]
Principal so transferred results in debasement of currency, but enhancement of SBP balance sheet. Extent of initial debasement is due to transfer of principal, which is augmented by further debasement when SBP realizes the accrued interest on this transaction. SBP (the lender) gets an advantage of "profit" through this transaction. Currency is debased even further when SBP transfers its "profits" to government and if it spends this on any activity other than retirement of existing debt.

(iii) According to Islahi, "Most Islamic jurists hold the view that a loan involving any advantage or benefit to the lender comes within the meaning of *riba*."[7]

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[5] Report on elimination of *riba*, Commission for Islamisation of Economy, Government of Pakistan, August 1997.
[6] Baeck (1991), p. 111.
[7] Islahi (1988), p. 136.

(iv) Principal so transferred creates a deception in the minds of many agents that government can use it for real beneficial activities like economic development and alleviation of poverty.

(v) According to Islahi (1988), "Al-Ghazali also warned about the consequences of debasement of the monetary unit." He (Al-Ghazali) says: 'To put a bad money into currency is an injustice for the reason that the person who makes a transaction with that money is harmed.' He further writes: 'Circulation of one bad dirham is worse than theft of a hundred dirhams, as theft is one sin and it is finished once for all; while spending bad money is an act of evil which affects all those who use it.'[8]

(vi) In reality, the principal so transferred has come about because of the decline in value of rupee held by each agent in the economy (either rich or poor). In other words this transfer has actually robbed many agents through creation of inflation tax (imposition of this tax does not require the approval of parliament!).

(vii) Islahi (1988) quotes from Ibn Taimiyah that "All evils (such as injustice, exploitation, etc.), on account of which interest is forbidden, exist in these transactions, perhaps with a greater degree of fraud, cheating and troubles."[9]

(viii) This transfer worsens the income distribution because the poor become poorer and the severity of poverty increases due to excessive inflation. While the rich are also negatively affected, but the extent is lower compared to those of poor.

(ix) According to Islahi (1988), Ibn Taimiyah "… opposes debasement in the currency and over-production of money." He (Ibn Taimiyah) says: 'The authority should mint the coins (other than gold and silver) according to the just value of people's transaction, without any injustice to them.'[10]

So besides describing this challenge of getting rid of inflationary debt, I also ask a simple question to *sharī´ah* Scholars, "shouldn't this transaction between SBP and government be prohibited completely?"

The current outstanding level of this debt is so high that it is difficult to envisage its elimination in a short period of time. A proposed

[8] Ibid., p. 240.
[9] Islahi op cit. p. 135.
[10] Ibid., p. 141.

amendment in SBP Act, 1956 envisages limiting this outstanding debt to a maximum of 10% of government revenues of previous year. A five year period is envisaged in the amendment bill to allow the government and SBP to bring it down from over 68 percent in December 2010 to 10% in a period of 5 years after this amendment becomes effective. This bill has been discussed and cleared by the National Assembly and awaiting Senate's approval for legislation.

This challenge will remain even after the legislation of enhancement in SBP powers. The government has to credibly commit and adhere to this law by lowering its deficit financing requirements. On the other hand, the SBP has to enforce this by not lending excess amounts. The real test for SBP will come after lapse of 5 year period allowed to government to reduce this debt significantly. Despite the enormity of this challenge, a significant portion of SBP debt can be reduced relatively easily, even from existing financial resources of the government of Pakistan. This assertion may seem surprising, but nevertheless true, as can be seen by looking at Table 3 which lists existing fiscal and financial resources of the government. The most surprising thing to note is the presence of surplus cash balances of government and public sector enterprises lying unutilized in several commercial banks (not with SBP). These balances together amounted to Rs 913 billion in December 2010, which means that 63.7 percent of SBP debt can be potentially retired by the use of existing resources. While this cannot be done with a stroke of pen at once, a practical approach would be to gradually withdraw these balances (say to the tune of Rs 20 billion per month), so that banking system is not suddenly affected with large withdrawals. If this advice is followed, stock of SBP debt can be reduced by Rs 480 billion in just two years. Furthermore, with the passage of time and government's commitment to future reforms, a complete elimination of government domestic debt held by SBP is likely to become a reality within seven years of the pending legislation of SBP's enhanced independence.

Great benefits are embedded in overcoming this challenge. Controlling inflation would become relatively easier, and there would be greater chances of SBP enforcement-induced behavior for fiscal prudence. This of course, is much easier said than done and it is precisely because of this reason, getting rid of SBP debt is the first and foremost challenge.

3. Second Challenge: Limiting the Excessive Expansion in Central Bank Balance Sheet and Conducting Monetary Policy

Before describing the second challenge, we have to first settle the question of what should be the primary objective of any central bank from the Islamic perspective. Wisdom of Ibn Khaldun seems to settle this question for good. According to Chapra (2010), "If one were to use modern terminology, one could say that Ibn Khaldun found a stable price level with a relatively low cost of living to be preferable, from the point of view of both growth and equity in comparison with bouts of inflation and deflation. The former hurts equity while the latter reduces incentive and efficiency. Low prices for necessities should not, however, be attained through the fixing of prices by the state; this destroys the incentive for production." It clearly seems that Ibn Khaldun's wisdom foresaw 'inflation targeting' many centuries ago, which was adopted by modern central banks just a couple of decades ago. Inflation targeting approach explicitly requires the primacy of 'price stability' as the main goal for a central bank, which Ibn Khaldun clearly advocated.

According to Mishkin (1999), those central banks that adopted this strategy, first brought down high or excessive inflation by controlling the quantity of money circulating in the system through control of central bank balance sheets. Wisdom of Al-Ghazali, Ibn Taimiyah and Al-Maqrizi foresaw this approach much earlier. They clearly saw inflation to be a monetary phenomenon i.e. debasement or over-production of money causes inflation and other injustices. Solution, therefore, is to remove the over-production of money (excess liquidity, or monetary overhang in modern terminology) from the system. This is what central banks open market operations intend to achieve. In simple words, if the government actions have created excess currency in circulation, it has to be drained back from the system to bring inflation down.

Overcoming the first challenge will, however, create a new challenge for the central bank. How will the central bank conduct its monetary policy when it does not hold any short-term government paper (T-bills)? The answer is that if the central bank is allowed to issue a *sharī'ah*-compliant instrument (against its assets) then it should not face any difficulties in mopping excess liquidity from the system whenever such a need arises. Also, if the central bank is allowed to subscribe to *sharī'ah*-compliant instruments issued by the government, it can use these

to manage liquidity through their outright sales and outright purchases from the financial institutions. Parallel approach would, of course, require the continuity of these transactions with conventional banks until full transformation. Also, the *sharī΄ah*-compliant instrument has to be tradable for these transactions to be permissible. This is possible if the instruments are based on *shirkah* and *ijara* basis.

Regarding the question of central bank subscription to *sharī΄ah*-compliant instruments, two questions would be worth exploring by the scholars. First, which of its resources will the central bank use to make these investments? Second, should the central bank be allowed to make this investment through a simple book entry? If allowed, it would be like using nothing to become a subscriber. Should this be permissible? Again I would request the *sharī΄ah* scholars and financial experts to explore this question. My suggestion would be to allow the central bank, if there are clear monetary policy needs to hold these instruments in the short-run, to the extent of deposits held by central bank (of financial institutions) due to cash reserve requirement (CRR). Also, a part of central bank profit can be earmarked for this kind of investment each year.

If a sufficient amount of subscriptions to *sharī΄ah*-compliant instruments are already held by the central bank, then there would be no need for it to issue its own *sharī΄ah*-compliant instruments. Excess liquidity can be drained by selling these instruments to financial institutions, and liquidity shortages can be addressed by purchasing these instruments held by the financial institutions in a similar manner, as is customarily done through open market operations. For this approach to be feasible, it will be necessary for the government to issue a *sharī΄ah*-compliant tradable short-term instrument of a maturity not exceeding one year. *Ijara sukuk* structures clearly make it feasible. Once issued and subscribed by Islamic (and conventional banks), these can be purchased by the SBP in smaller sizes to gradually build an inventory specifically for the purpose of conducting open market operations. Till such time, it has to rely relatively more on the instrument of cash reserve requirement (CRR).

While it may seem at present that SBP will be constrained severely by its inability to issue its own *sharī΄ah*-compliant instrument in large sizes, this will actually be the greatest advantage in controlling its balance sheet.[11] For any central bank, a benefit embedded in the use of *sharī΄ah*-

[11] Real assets of SBP, comprising of property and equipment amounted to Rs 17.9 billion as on end-June 2010. However, the valuation of property was done four years earlier; next valuation is due on end-June 2011. If gold reserves are also included in real assets,

compliant instruments is the self limiting character of Islamic finance. There would be much lower chances of excessive expansion in central bank balance sheet that becomes a primary cause of high or hyperinflation. At the same time there would be no risk of unreasonably low expansion in the reserve money due to ample powers of the central bank to purchase *sharī΄ah*-compliant instruments held by the financial institutions. The main challenge is to have an instrument that conforms to *sharī΄ah* for both ownership and tradability in secondary market. Also, the size of these instruments held by the banks should be reasonably larger than the regulatory-induced (SLR) demand for them so that active trading can take place among the banks and SBP is able to build an inventory for conducting open market operations.

4. Third Challenge: Replacing Domestic Debt (held outside SBP) with *sharī΄ah*-compliant Instruments

This is the area where initial progress has occurred rapidly within last 2-3 years after the launch of Rupee denominated Government of Pakistan Ijara Sukuk in September 2008. Although the share of *Ijara* Sukuk in total domestic debt is only 2.5% its share in permanent debt is 14.4% (December 2010). *Ijara* Sukuk not only has the potential to meet the demands of Islamic banks to fulfill their SLR requirements, it is as attractive to commercial banks and also offers a profitable mode of investment for individuals. The main challenge for the government is to identify the assets, with full documentation and valuation, which can be based to structure the required *ijara* Sukuks. Meeting this challenge would also result in a benefit of financial prudence because the amount of resources raised would be limited by the value of identified assets. There is also a danger here that if government is not firmly committed to transform the existing debt towards *sharī΄ah*-compliance, it can use the new instrument to raise additional resources for deficit financing, instead of using these to replace existing *riba*-based instruments.

Hence, government has to be fully committed to gradually transform the debt, following a parallel approach, to *sharī΄ah* compliant instruments. Transformation to the extent of value of identified assets would not be very difficult, but a part of the debt has to be retired to achieve full transformation. What is the size of real assets held by the

these amount to Rs 219.9 billion on end-June 2010, valued at market prices. It may be worthwhile for the central bank to slowly acquire real assets for the purpose of issuing *Sharī΄ah*-compliant instruments against those assets to meet the monetary policy requirements.

government, both federal and provincial combined? Based on the work of Arby (2008) on estimation of national income and investment, a ballpark estimate of the value of government real estate capital stock was Rs 2413 billion in FY10. Domestic debt excluding SBP held portion was Rs 3481 billion. This means that even after retiring the SBP debt, government assets may not prove sufficient to replace the existing domestic debt with *sharī′ah*-compliant instruments. Moreover, most of the existing domestic debt is held by the federal government while most of the assets are owned by provincial governments[12]. If the share of federal government is only 26.8%, it can only issue *sharī′ah*-compliant debt instruments to the tune of Rs 647 billion.

Above numbers are, of course, only meant for illustration of challenge of replacing existing debt to asset-based *sharī′ah*-compliant instruments. What is needed urgently is a survey of all government assets for the purpose of identification, documentation and valuation of each asset. While this may prove to be a tedious task for the government, it is necessary to undertake this to speed-up the progress of transformation towards Islamization of existing debt. This will also help the government to issue foreign exchange denominated *sukuk*s in international markets in future as it did in 2005.

There are many benefits embedded in overcoming this challenge. If the government limits its borrowing to the extent of value of its assets, it will pave the way for the private sector to raise more resources to undertake productive economic activities that promote investment and growth. Combined value of assets of the private sector is usually much larger than those of government. Private sector productive activities are usually constrained by the government debt raising unproductive activities and not by the dearth of real assets. Greater private sector productive activities will enable the government to raise more taxes. This is also realized in conventional interest-based system and to limit government fiscal excesses, fiscal responsibility and debt limitation are usually legislated in many countries. These laws seldom work because the limiting mechanism is *ad hoc* and based on the size of the GDP of the economy, and not the value of real assets of the government.[13] Self limiting nature of

[12] Past 46-year cumulative streams of federal and provincial investments show that the share of federal government in capital stock may be no more than 26.8% in FY10.

[13] Pakistan also has a "Fiscal Responsibility and Debt Limitation Act 2005", which required the revenue deficit to become nil by 30th June 2008 and the 'Total Public Debt' not to exceed 60 percent of GDP after 30th June 2013. Former requirement had already

the *sharī΄ah*-compliant instruments is a joint blessing for both the public and private sectors.

5. Fourth Challenge: Establishing a Benchmark Rate of Return for *Sharī΄ah* Compliant Instruments

This may not look like an immediate challenge, but imagine a situation in future when close to 50% of domestic debt has already been transformed through *ijara sukuk* or other *sharī΄ah*-compliant instruments. Clinging to *riba*-based benchmark will then become problematic. Despite a necessity at this stage and favourable opinions of *sharī΄ah* scholars on permissibility of this practice, considerable skepticism and cynicism exist even among educated individuals, which negatively distort their perceptions about Islamic financial practices. This may limit the potential demand of this product among them, although regulatory-induced demand through SLR requirement of SBP and Islamic banks' demand for medium to long-term investments is unlikely to be diminished. Nevertheless, a considerable part of existing debt cannot be transformed into *sharī΄ah*-compliance solely on the basis of institutional participation. So even if there is no immediate challenge, it would be fruitful to start thinking about how the benchmark is going to change when half of domestic debt becomes *sharī΄ah*-compliant.

Usufruct derived from a real estate can be valued at the potential rent it can earn when rented out. Annual rate of rental would be the annual rent amount expressed as percent of the value of real estate. Just for illustration, if the value of a real estate is Rs 10 million and capable of earning a monthly rent of Rs 125,000, then the annual rental rate is 15%. One can establish a benchmark for office space by conducting surveys that estimate both the value of office space as well as rent. Surveys in major cities can be conducted to establish an "Office Price Index" and an "Office Rent Index". Annual rental rate can be easily derived from these indices. An extensive purposive survey can be done initially to establish these rentals, which can be updated every six month through smaller surveys. Extensive surveys can be done every five years to keep the benchmark current with structural changes taking place in the real estate sector. Sample size of these surveys could be kept very small; no more than a hundred or so. What is more important is the careful selection of properties and the quality of process which ensures soliciting market values of both real-estate and rents. Transparency of survey methodology and public availability of updated indices every six month would be of paramount importance.

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been breached and the likelihood of latter also looks difficult as Total Public Debt was 62.1 percent as on 30th June 2010.

Annual rental rates, estimated in this manner, will show some fluctuations, but these fluctuations are unlikely to be very large unless huge differentials emerge between growth rate of office property values and growth rate of market rent of office space. This is because annual rental value is a ratio of market value of rent to the value of property and its variation will depend on the difference between growth rate of numerator and the growth rate of denominator. For example, if annual rental value is R, property value is V then the annual rental rate $r = (R/V)$. Also, if the numerator is growing at an annual rate of increase of g, which is different from the growth rate of denominator h by a fraction of d then the new annual rental rate $r_1 = r + dR/[V(1+h)]$. As a specific example based on earlier illustration, assuming $r = 15\%$, $g = 15\%$ and $h = 10\%$ i.e., $d = 5\%$ then $r_1 = 15.68\%$. Purpose of this illustration is to show that the fluctuations will be based on what is happening in the real-estate sector of the economy, which is likely to affect the growth rates of rents and property values in a different manner, resulting into a new rate of rental, as it should be.

An alternative approach, based on surveys of small number of knowledgeable real-estate agents, can also be considered. These agents can be asked every six month (or every quarter) about their expert opinion on the values and rents of primary office space in major business centres. This survey may prove to be less difficult to implement compared to earlier suggestion. Moreover, instead of constructing office price and rent indices, median (or any other appropriate non-parametric central tendency measures) rental yield can be selected as the benchmark yield and tracked periodically.

Similar survey-based techniques may also be used to establish benchmarks for musharaka-based instruments by estimating profit rates in appropriate sectors of the economy. My main purpose of this discussion is that without any efforts and experimentation at this stage, it would become very difficult to change the existing practice of adopting riba-based benchmark for *sharī΄ah*-compliant instruments. It is difficult to imagine that a benchmark, once established, will change by itself in future.

6. Fifth Challenge: Publicizing the Distinguishing Features of *sharī΄ah*-compliant Instruments

A much broader challenge is to transform the mindset of educated Muslim elite in favour of the genuineness of Islamization efforts thereby convincing them that the instruments developed so far are indeed different from conventional interest-based products, besides conforming to

sharī΄ah. A carefully launched publicity/education campaign to remove the cynical perceptions of a large number of Muslims in Pakistan will go a long way in converting the faith-based latent demand to an effective demand for Islamic financial products. A recent survey completed at the State Bank of Pakistan indicates that while the 95 percent respondents believe interest rate charged by commercial banks to be haram, only 44 percent effectively demand the use of Islamic financial products. A considerable size of the respondents perceived Islamic banking mainly as *qarz-e-hasan*[14]. Awareness about other *sharī΄ah*-compliant products was much lower. While the results are by no means alarming, but considerable efforts are needed to increase awareness about existing Islamic financial services already available in the market. There seems to be a considerable availability of products (supply), but the latent demand has to be induced (through publicity/education campaign) to become an effective demand.

In the case of Government *Ijara sukuk*, the demand-supply balance is currently different from the above scenario as the supply has recently started, which is primarily meeting a regulatory-induced (SLR) demand for these instruments. However, the government has recently allowed individuals to hold these as well, if not acquired through initial auctions. This means that Islamic banks can sell these in secondary market to individual investors. SBP instructions and guidelines to financial institutions have already been issued in this regard[15]. From the supply side, the government intends to issue *ijara sukuk* in substantial size each quarter.

Are individual investors aware about the existence of these instruments? Perhaps not, and unless these are publicized by the issuer (GOP), manager (SBP) and retailers (mainly Islamic banks), we may see a situation in future where these are primarily held by financial institutions, despite increased supply. This publicity need can be addressed by a participatory approach among the three stakeholders. Easy to understand brochures can be designed to persuade individual investors to increase their demand. Individuals' awareness about *ijara sukuk* will also increase by this approach. Moreover in brochures and advertisements, the distinguishing features of *ijara sukuk* (compared to a plain vanilla bond) should be overemphasized, without de-emphasizing the similarities. Cynical views of individuals (if any) due to the similarities with plain

[14] The Demand for Islamic Banking: A Case Study of Pakistan, an ongoing study at SBP nearing completion.

[15] State Bank of Pakistan, FSCD Circular No.13, September 06, 2008.

vanilla bond should only be addressed through greater emphasis on ownership aspect (in a real asset) of *ijara sukuk* and earning a *Halal* rate of rental due to the beneficial (proportionate) ownership of the real asset. Documentation of owned assets for the period of *ijara* should be easily accessible to each individual investor. Due to the complex nature of documentation, easy to understand summaries should also be available to investors.

The need to expand the skilled human resources in the tenets and practices of Islamic finance can hardly be overemphasized. This resource need will rise very quickly with speeding of transformation process and will affect all stakeholders including the Government of Pakistan, State Bank of Pakistan and Islamic as well as conventional banks. Active intervention of the central bank would be desirable to chart out a strategy to fulfill this important need. It is proposed that the *sharīʹah* Board of SBP takes up this and ancillary challenges to put Pakistan firmly on the gradual path towards full transformation.

7. Conclusion

Progress in Islamization of domestic government debt in Pakistan had been relatively slower than the progress in Islamic banking in the first decade of twenty-first century. The first and the foremost challenge is to eliminate the domestic debt held by the central bank. Second challenge is the acquirement of *sharīʹah* compliant instruments by SBP to conduct monetary policy. Third challenge, where a definite progress has been witnessed recently, relates to the issuance of Government of Pakistan Ijara Sukuk that has the potential to replace permanent (long term) portion of domestic debt. Replacement of domestic debt will be limited by the availability of government owned assets. It is proposed that an asset survey be undertaken by the government to identify and document these assets for enabling future issuances. Fourth challenge, though not an immediate one, is to actively experiment towards creating appropriate non-interest-based benchmarks for linking *sharīʹah*-compliant returns. The fifth and final challenge is to gradually transform the mindset of investors towards active acceptability of *sharīʹah*-compliant products through publicity campaigns.

شرع برخیزد ز اعماق حیات
روشن از نورش ظلام کائنات
گر جہاں داند حرامش را حرام
تاقیامت پختہ ماند ایں نظام

The sharī΄ah grows out of life's bosom;
Its light illumines the darkness of the universe.
If the world were to accept its judgment
regarding what is forbidden,
This system would endure forever.

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Annexure

Table 1

Pakistan's Debt and Liabilities Summary (in Billion Rupees)

End Period	FY07	FY08	FY09	FY10	Dec-10
I. Government Domestic Debt	2,610	3,275	3,861	4,653	5,294.7
II. Government External Debt	2,151	2,762	3,452	3,667	3,838.0
III. Debt from IMF	85	91	419	690	748.8
IV. External Liabilities	49	88	104	96	94.3
V. Private Sector External Debt	78	128	198	218	226.8
VI. PSEs External Debt	73	82	87	83	70.6
VII. PSEs Domestic Debt	104	137	290	375	390.7
VIII. Commodity Operations Debt*	99	127	336	415	364.3
A. Total Debt and Liabilities (sum I to VII)	5,249	6,691	8,746	10,196	11,028.1
B. Total Public Debt (sum I to IV)	4,896	6,216	7,835	9,106	9,975.7
C. Total External Debt & Liabilities (sum VI to VIII)	2,436	3,152	4,259	4,754	4,978.4
D. Commodity Operation and PSEs Debt (Sum VI to VIII)	275	347	713	873	825.6
As a percentage GDP					
Total Debt and Liabilities	60.54	65.3	68.7	69.5	
Total Public Debt	5604	60.7	61.5	62.1	
Total External Debt & Liabilities	28.1	30.8	33.4	32.4	
PSEs Debt & Liabilities	3.2	3.4	5.6	5.9	
Government Domestic Debt	30	32	30	32	

*This includes borrowings from banks by provincial governments and PSEs for commodity operations.

Notes:

1. Debt and Liabilities show end-period outstanding positions
2. For conversion into rupees from US dollars, weighted average customer exchange rates prepared by Domestic Markets & Monetary Management Department have been used for month end exchange rates.
3. Data pertain to end period.
4. Data for Nov-10 is provisional

Table 2
Government Domestic Debt (Major Instruments)
(in Billion Rupees)

End Period	FY07	FY08	FY09	FY10	Dec-10
I. Permanent Debt (1+2+3)	553	608	678	794	909.6
1. *Ijara* Sukuk 3 years (shariah compliant)	0	0	28	42	131.3
2. Pakistan Investment Bonds (PIBs)	353	412	441	505	522.1
3. Prize Bonds	175	183	197	236	252.1
II. Floating Debts	1,108	1,637	1,904	2,399	2,859.2
1. Market Treasury Bills	656	537	796	1,227	1,426.8
2. Market Related Bills (MRTBS held by SBP)	452	1,053	1,108	1,125	1,432.5
III. Unfounded Debt	940	1,020	1,271	1,456	1,524.3
1. Saving Schemes (other than Prize Bonds)	830	911	1,163	1,350	1,416.0
IV. Foreign Currency Certificates (held by residents)	10	9	8	3	16
Government Domestic Debt (I+II+III+IV)	2,601	3,275	3,861	4,653	5,294.7
Memorandum Item					

Table 2. Government Domestic Debt (Major Instruments)

(In Billion Rupees)

End Period Stock	FY07	FY08	FY09	FY10	Dec-10
I. Permanent Debt (1+2+3)	553	608	678	794	909.6
of which					
ijara Sukuk 3 Years (*sharīʹah* Compliant)	0	0	28	42	131.3
Pakistan Investment Bonds (PIBs)	353	412	441	505	522.1
Prize Bonds	175	183	197	236	252.1
II. Floating Debt	1,108	1,637	1,904	2,399	2,859.2
of which					
Market Treasury Bills	656	537	796	1,227	1,426.8
Market Related Treasury Bills (MRTBs Held by SBP)*	452	1,053	1,108	1,125	1,432.5
III. Unfunded Debt	940	1,020	1,271	1,456	1,524.3
of which					
Saving Schemes (Other Than Prize Bonds)	830	911	1,163	1,350	1,416.0
IV. Foreign Currency Certificates (Held by Residents)	10	9	8	3	1.6
Government Domestic Debt (I+II+III+IV)	2,610	3,275	3,861	4,653	5,294.7
Memorandum Items:					
sharīʹah Compliant Share in Government Domestic Debt (%)	0.0	0.0	0.7	0.9	2.5
sharīʹah Compliant Share in Permanent Domestic Debt (%)	0.0	0.0	4.1	5.3	14.4
Share of Permanent Debt in Domestic Debt (%)	21.2	18.6	17.6	17.1	17.2

Notes:

* Outright Sale of MRTBs is not included

Nov-10 data is provisional

Table 3. Fiscal & Financial Resources and Uses
Amount in Billion
Pak Rs.

	FY07	FY08	FY09	FY10
Total Revenue	1,298.0	1,499.4	1,850.9	2,078.2
Total Expenditure	1,800.0	2,276.5	2,531.3	3,007.2
Fiscal Deficit	-377.5	-777.2	-680.4	-929.1
SBP Profit	108.7	164.8	204.2	186.7
Government Domestic Debt	2,610.4	3,274.7	3,860.7	4,652.7
Government Domestic Debt Held by SBP[1]	455.2	1,056.3	1,111.0	1,128.1
Government Cash Balances in Scheduled Banks[2]	366.4	403.2	455.8	552.9
PSEs Cash Balances in Scheduled Banks[3]	272.4	291.4	280.2	320.5
GDP (MP)	8,673.0	10,242.8	12,739.3	14,668.4
	% Change			
Total Revenue	20.6	15.5	23.4	12.3
Total Expenditure	28.4	26.5	11.2	18.8
Fiscal Deficit	16.0	105.9	-12.5	36.5
SBP Profit	59.5	51.6	23.9	-8.6
Government Domestic Debt	11.7	25.4	17.9	20.5
Government Domestic Debt Held by SBP	-11.0	132.0	5.2	1.5
Government Cash Balances in Scheduled Banks	28.0	10.1	13.0	21.3
PSEs Cash Balances in Scheduled. Banks	6.4	7.0	-3.8	14.4
GDP (MP)	13.8	18.1	24.4	15.1
	% of GDP			
Total Revenue	15.0	14.6	14.5	14.2
Total Expenditure	20.8	22.2	19.9	20.5
Fiscal Deficit	-4.4	-7.6	-5.3	-6.3
SBP Profit	1.3	1.6	1.6	1.3
Government Domestic Debt	30.1	32.0	30.3	31.7
Government Domestic Debt Held by SBP	5.2	10.3	8.7	7.7
Government Cash Balances in Scheduled Banks	4.2	3.9	3.6	3.8
PSEs Cash Balances in Scheduled. Banks	3.1	2.8	2.2	2.2
	% of Total Revenue			
Total Expenditure	138.7	151.8	136.8	144.7

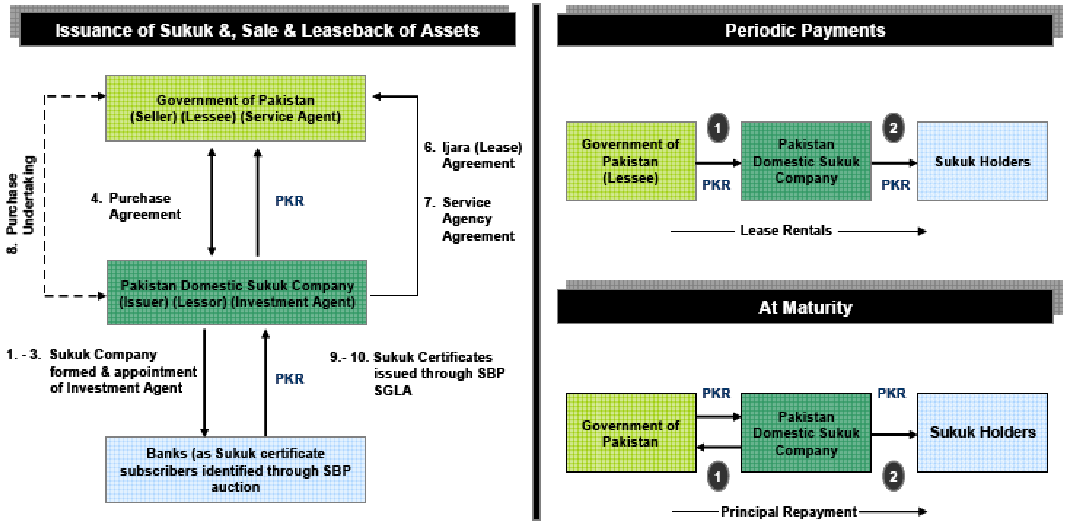
Fiscal Deficit	-29.1	-51.8	-36.8	-44.7
SBP Profit	8.4	11.0	11.0	9.0
Government Domestic Debt	201.1	218.4	208.6	223.9
Government Domestic Debt Held by SBP	35.1	70.4	60.0	54.3
Government Cash Balances in Sch. Banks	28.2	26.9	24.6	26.6
PSEs Cash Balances in Sch. Banks	21.0	19.4	15.1	15.4
GDP (MP)	668.2	683.1	688.3	705.8

1. Includes Government Securities held by SBP plus Treasury Bills held by SBP only.
2. Government Deposits with Scheduled Banks which include Deposits of Federal & Provincial Governments and Local Bodies.
3. Non-Financial Public Sector Enterprises

ANNEXURE – "C"

Structure and Documentation Brief

I. Facility Structure Synopsis – Diagrammatic Illustration



II. Facility Structure Synopsis – Explanation:

A Special Purpose Company, wholly owned by the Ministry of Finance, Government of Pakistan, has been formed to act for and on behalf of Sukukholders, namely, Pakistan Domestic Sukuk Company Limited (the "SPC").

State Bank of Pakistan ("SBP") will conduct an auction by which Sukuk Investors will be identified.

Pursuant to the **Certificate Subscription Undertaking,** Sukuk Investors will appoint the SPC as Investment Agent.

The SPC will enter into a **Purchase Agreement** with Government of Pakistan or National Highway Authority ("**GOP**") for purchase of certain pre-identified tangible assets, such as a portion of the M3 Motorway for the first Sukuk issue ("Sukuk Assets") at an agreed price ("Purchase Price") equivalent to the Sukuk issue ("Sukuk") amount.

Pursuant to a **Declaration of Trust**, the SPC (as Trustee) will declare its responsibilities towards the Sukukholders.

The SPC (as Lessor) will enter into an **Ijara Agreement** with GOP (as Lessee) wherein SPC will lease the Sukuk Assets for a fixed period, being 3 years in case of the first Sukuk issue. Lease Rentals will be paid on a semi-annual basis, i.e. a total of 6 lease rental periods for the first Sukuk issue.

Lease Rental means an amount equal to the product of (i) the Rental Rate for such rental period, (ii) the Margin, (iii) the number of days in such rental period divided by 365, and (iv) the face value of the Sukuk issue, plus the Supplementary Rental for such Rental Period

Supplementary Rental means expenses incurred by the Service Agent in respect of maintenance,